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The Crisis and the Economy

Dimitar Chobanov

Recently, the global financial crisis has been the subject of many comments since it is expected to affect to a greater degree the development of international markets. The expected slowdown of the growth of the major economies, such as the USA and the European Union, is spreading over the rest of the world through trade and capital movements. The increasing integration of the Bulgarian economy with the European economies, however, is making it more susceptible to unfavorable developments and is raising questions about the effects of the current situation.

An important issue, in this case, is how the financial crisis arose. The main factor is the monetary policy of the major central banks around the world, which for a long period since 2000, was directed towards maintaining low interest rates. In the USA the federal funds rate fell down to 1%, while in the Euro zone to 2%. Low interest rates practically mean faster growth of the money stock. In such case the money supply is greater than the demand, which leads to price increases. Something more – the prices of certain assets increase significantly by forming the so called “bubbles”.

The growth of the economy is stable if it is due to increased savings. Under the current conditions, however, this is not always the case. The monetary system, dominated by the central banks, allows for printing money, when they are not covered by goods and services and they practically appear from thin air. The entrepreneurs receive wrong signals as

a result from the higher prices in certain sectors, which are a result of additional liquidity in the economy. The initial effect is similar to that from the increased savings; however the long term effects are different.

The investments in the economy depend on the demand and supply of borrowing funds. The increase of the supply of borrowing money pushes the interest rates down and increases the supply of investment credits. When savings are growing that means the people are prepared to defer current consumption against the future one. In other words, at a later stage they would be looking for more goods and services, which could be met only by greater production. The main thing is that the higher savings lead to higher investments, which increases the production capacity and the economy grows.

The effect of the monetary and credit expansion is different. Injecting more money reduces the interest rates, investments increase, but savings actually fall due to the lower return. In such case the interest rate deviates from the so called natural level. For that reason its maintenance could be achieved only by further increase of the money supply. A disparity is created between the savings and investments and as a result temporarily growth is stimulated, but it is not sustainable and is followed by a downfall, since the investment must adjust to the level of savings.

The investments, however, represent a multi-stage process. The interest rate controls not only the level of investments but the distribution of resources in the investments. The different

investment relate differently to the consumer goods. Research and development for example is more distant from the time of production of end-user consumer goods. The sensitivity to the interest rates increases with increased remoteness in time from the end use.

When the interest rates are reduced the investment in long term capital is stimulated, thus leading to changing the structure of production. If it is a result from money expansion however, it does not correspond to the expectations of the consumers. Hence, the received signal is wrong if there is no growth of savings. The misbalance between production and consumption leads to slowdown. The artificially maintained low interest rates are replaced with a high real interest rate, since the resources are reduced. The slowdown leads to liquidation and restructuring of the capital, through which the production activities are brought in line with the consumer preferences.

Identification of the misallocation of resources in time must be based on defining the flourishing and slowdown of the economy. Actually, the period when wrong decisions are taken must not be defined as growth and the subsequent restructuring and liquidation as a slowdown. The second period for all practical purposes represents corrections of distortions in the markets of labor and capital. During the artificial growth stage unemployment is low but when it is over workers are made redundant and the employment is reduced.

Such development could be expected in Bulgaria. Although the money supply in the country is to a greater extent orientated towards the preferences of consumers, the currency board is based on the policies of the European Central Bank (ECB). Hence, when the ECB maintains low basic interest rates this is transferred in Bulgaria as well. This contributes to the faster growth of the money supply

and the credit activity, increases inflation, wages grow faster, and the current account deficit is greatly increased. These are symptoms that the money supply is greater than the demand for money, which leads to effects described above.

Hence, we could expect all negative consequences from the artificial growth. The economic growth would probably slowdown due to the liquidation of the malinvestments, which will lead to lower investment activity. Employment would be reduced and fewer new jobs would be created. It is possible that some of the commercial banks would have liquidity problems, which would effect their propensity to lend money. The interest rates would continue to increase which would lead to increase in the cost of servicing the credits.

The consequences for the state budget could also be negative. From one hand, the pressure for higher social spending would increase, while on the other hand it is possible that revenues would be reduced due to the lower economic activity. One of the factors for that is the slowdown of the rate of imports due to the lower demand.

As a whole, the future of the Eurozone does not look positive. This would have inevitably an effect on Bulgaria, which would lead to restructuring of the investments. The reduction of the prices of the financial assets must serve as a lesson to the investors, that they must use better judgment in their actions. In this case it is necessary they to bear the responsibility for their own actions and not to expect the government to compensate them for their mistakes. This applies for the commercial banks, which must be particularly careful with respect to managing the emerging risks.

Should the State pay for advertising of the tourist business?

Adriana Mladenova

During 2008 every second the Government is spending minimum 805 leva or 2.9 million leva per hour and 69.5 million leva per day. You are probably asking yourself where is all that money going? It is spent on various "priority" projects and initiatives of "state importance".

The latest idea, which is promoted in the public space by the newly elected chairman of the National Board of Tourism Mr. Krasimir Gergov, is to set aside budget funds to advertise Bulgaria as a tourist destination. We are talking about 75 million leva. According to the National Board the tourist business needs "*an adequate partner in the State, with whose assistance to move the tourist industry*".

If you are now wandering and asking yourself isn't the tourism one of the fastest developing

sectors of the economy, the answer is yes! The visits of foreigners to the country with the purpose of tourism have increased by 40% from 2002 according to the National Statistics Institute (NSI), while the hotels revenues have increased by more than 200% during the same period. A logical question arises - why is it necessary for the State to subsidize this sector, when it is apparent that it is doing very well?

Not always the decisive factor is the economic logic. When you are spending someone else's money, the incentives are distorted and decisions are often taken to benefit certain circles and politically strong groups, not necessarily to benefit the society. The problem is, that economically unfounded ideas could be presented to the public in such way as to look as something positive in the eyes of the taxpayers. In this case they are talking that 1.5% of the revenues generated by tourism in the economy would be set aside for advertising. However it does not mean that only the tourist business will pay for this type of advertising. Just the opposite, the tourist companies (and not only they) would profit at the expense of the taxpayer. In other words every family must set aside approximately 15 EUR per year for someone to write advertising strategies, consultations and the state to conduct the actual advertising.

The questions

- Is there a kind of market failure, in order to justify the need of State support for the sector? Since it is one of the businesses considered with the best future, apparently not. In contrast to the pessimistic statements, during 2008 Bulgaria has risen by 11 places upwards in the global rating provided by the World Economic Forum for competitiveness of the tourist sector – from 57th to 43rd place among 130 countries.
- Why is the State expected to develop destinations? That is not its task; it does not have the knowledge or the expertise in the state employees.
- Does the state know (or the consultants which it would hire) what kind of tourist business to promote and where to direct the focus – sea, mountains, cultural, eco, country tourism? The taking of a central decision for common advertising of the country and creation of a certain image could lead to negative consequences for

some of the participants in the branch and to change the incentives of the market. It is possible that would be favoritism of a specific kind of tourist business at the expense of another type.

- Would the money be spent effectively? It is proven theoretically and empirically that the public sector is much more ineffective than the private sector in implementing projects which actually belong to the sphere of the private business.

Another proposal, which is creating confusion, is the desire to create a new Ministry of tourism in Bulgaria. Now, when we expect changes in the government mandates, many lobbying groups are getting active in order to gain greater power and resources. However, there is no need to create a brand new ministry, which would mean greater and slower administration (political cabinet, chief secretary, etc.) and unnecessary bureaucracy in the sector. Similarly, it is not necessary to have a strategy and a central plan to develop certain sector of the economy.

Another argument in support of active government policy is the necessity of maintaining and marketing of the cultural sites. Taking into account that there is a special department within the Ministry of culture for protection of cultural monuments of as well as the “National Institute for Cultural Monuments”, creating an additional administrative unit means not only wasting funds but also overlapping of functions and a way more difficult coordination between the units. That leads to inconsistent policies.

What the State could do for the tourist business (which applies for all other economic initiatives in the country as well), is the following:

- Simplify the regulations of the business;
- Creating a working judiciary system and protection of the investors' rights;
- Observing the rights of ownership;
- Creating a favorable environment for conducting business, such as low taxes, equal treatment of the business, presence of transparent rules and friendly administrative procedures;
- Maintaining a stable political situation.

All of these measures would have a proven positive effect on the image of the country. The State must concentrate on that. Let the advertising be left in the

hands of the private sector. Because the market knows best what are the customers' needs and how to attract their interest.

Who should be the licensor – the State or the private sector

Veliko Dimitrov

It became known several weeks ago that several professional organizations from the truck industry have joint into confederation. There is nothing wrong with this type of association – it is voluntary. To some extent one could say that this is an alternative to corporate mergers and takeovers from the point of view of the positions of negotiations with the trade unions and the State by the entrepreneurs. Sometimes more, sometimes less successfully, these organizations, together with their other activities such as training, mutual consultations, etc., are fighting stubbornly against the attempts of the politicians and bureaucrats (shortly the State) to create additional costs for the private sector, respectively worsen the business environment¹. We are talking mainly about the various types of regimes and mainly about licensing regimes, multiple submission of the same information, price limitations in a non-monopolistic sectors, etc.

One trend is noticeable in the last few years, which may have extremely negative effect on the development of many sectors – instead of promoting simplification and reduction of the number of regimes, some branch organizations and their unions, publicly express the desire they alone to become the factor, which takes decisions and gives permissions. Two years ago such idea was brought up by the building sector and at the beginning of this year the debate was in general and together with the observation the “state employee holds the golden pen” were put forward ideas that the regulation process should be taken away from

the administration and should be given to the business, i. e. representatives of the business should regulate the existing as well as the future companies. This according to some must lead to “clearer rules and transparency of the sectors”. In reality it is unlikely to find people who would support the claim that the state employees in Bulgaria implement the regimes in the most effective manner – it is a fact that they work slow, the electronic exchange of documents exists only in the Government's strategies, the feeling about corruption according to some international and local organizations is high, there are practices to jump lines, etc. The economic effects of this entire situation are clear – lower effectiveness, greater costs and looking for higher return on investment by international and local investors (which naturally reduce its quantity). The question is however, what would help the transfer of power to issue permits to the private sector, i. e. in general representatives of each branch to have the right to decide which companies would be allowed to manufacture and provide services and which would not. The answer is simple – absolutely nothing. For sure one could expect the enlargement of the existing problems and appearance of new in the following areas:

Corruption and the entry into the sector

If at present there is corruption, it is mainly in two directions: the government employee thrives to get higher income and the employee has been paid by for example competitive company to stop or create difficulties to some other company. In both cases the issue is to get higher income without the existence of definite and strong personal interest, beyond this additional income. If the right to issue permits however was exercised by the branch organizations we could add to this material interest one additional which is much more serious – protection of their own or represented “internal” organizations from entry into the sector of outsiders. In other words, the stimuli to close the entrance to the sector are much greater and respectively the illegal payments and additional agreements would increase.

¹Naturally I do not claim, that all legal requirements lead to greater costs, than benefits to society, as probably the most suitable example for that is the stricter regulation of the financial sector, which is protecting to some extent the financial system from crisis and the saving of the people from unscrupulous financial institutions. On the other hand however, in the real sector exist many requirements, which limit its development – tobacco, all crafts (over 100 of them) etc.

Facilitating the business

If the transfer of authority is mechanical, without any changes in the complexity of the procedures, scope and number of regimes, we could not speak about the improvement of the business environment even only according to this parameter alone. To this we must add the more difficult entry into the sectors with all negative consequences to competition, prices and quality

Lower budget costs

One of the few logical at first glance explanations of the favoring by the State of such intentions (but certainly not the leading) is that the costs of the administration would be lower. However, this is not likely to happen, since, as for example minister Mutafovich stated, the State would still attempt to monitor and control the processes. For this job naturally would be required employees, probably the same which are currently administering the issuing of licenses and permits. In other words, if until now the control was only along the line of the higher level within the administration now the chain would extend with more levels which operate on a branch level. Naturally the organizations themselves would require administrators, which to manage the processes and to provide internal control. Over all, achieving lower budget costs is not likely to happen, while for the economy as a whole they would certainly increase.

Licensing is always related to additional expense. Apparently, however, the negative effects on the

economy would be much less if this activity is performed by the State and not the private sector, which has many more stimulus to defile the process than any other state employee could or would be willing to. There are no economically based arguments, which could defend the transfer of power or regulatory functions to the private sector, and as a result the branch organizations should not attempt to achieve state-like status, but to direct their efforts (and not only they) in the following two directions:

- The regulation regimes to be reduced to two types: license and registration. To observe strictly the principal that a licensing or registration regime could be introduced only by a law, hence the Council of ministers or the separate ministries, agencies, and local structures could not introduce regulation regimes at will;
- To terminate the practice at the entrance of a given profession or craft (with few exceptions, one of which is the financial sector) to require permits, certificates at cet. Such documents could be used only as proof of higher qualification or some international affiliation, but not as a barrier to practice certain activity.

Murders and the economy

Zornitsa Manolova

The Bulgarian people are witnessing a large number of scandals, frauds, plunders, rackets and murders. During the last week the criminals again proved themselves – crimes during daylight, undiscovered witnesses and undiscovered perpetrators. On Sunday and Monday were executed two murders for political and economic reasons – a writer who was describing the underworld in Bulgaria and a company director.

All this is not new. During years after the transition the ordered murders in Bulgaria increased sharply when wealth and territories were distributed, old accounts were settled and to take new positions. During the chaos of the transition years, when the State was unable to maintain public order, the grey

economy and the black markets took a significant share of the economy. The non formal groups of that time play the role of judge and power.

Usually the criminals do not attempt to get justice in court, thus the decision is to order murder, which in many cases is demonstrative. The road to wealth in those years looks like closely link to the risk of “deadly” consequences. Bulgaria passed through murders in all sectors of the economy – from the grain business and the industry to the politicians. Taking someone’s life became an expression of position and interests.

The problem is not in the several murdered criminals with doubtful reputation but the degree of finding and prosecuting the perpetrators Who is responsible in that case and does it mean that the governments with their actions simply take side in the “disagreements” of the criminal groups? With crime of that size usually the

government creates working groups and co-ordination centers, where many specialists in criminal investigations and experienced field personnel attempt to discover the perpetrators. In many of the cases, however, there is not result, although enormous amount of resources have been put to work. Obviously this is a big problem of law enforcement.

These events alarmed the European Commission, which reminded several times that Bulgaria must undertake urgently measures to fight the organized crime and corruption, because such actions take away from the country a lot of money, provided by the EC, as we have been convinced recently.

It seems that we must think of building more stable and more transparent institutions in Bulgaria, where corruption is widely spread. This will increase the number of cases solved and would limit the possibility of their execution.

When the link between the government and the organized crime is destroyed, the problems would be reduced sharply, although they would not vanish. It is important to reduce the economic stimuli for the existence of gangsters, mafia, grey economy and black markets.

Naturally the economy could not clean itself from such actions. They exist everywhere around the world and are always a known percentage. There are many examples in the countries in transition as well as in the developed countries with market economy and developed democracy. At the same time there are many examples of reducing the organized crime and controlling corruption on a World scale and in particular in the countries from the European Union. In order to continue forward with our economic development we must really do some work.

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